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The Third Plenum and Economic Reform

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In mid-November the Central Committee, formally the ruling body of China's Communist Party, met in its Third Plenum. It was predicted ahead of time to be an exceptionally important meeting, second perhaps only to the Third Plenum of 1978, which elevated Deng Xiao Ping to being the paramount leader and led to major reforms of the Chinese economy. Against that expectation, the statement to emerge from the Plenum was something of a disappointment, at least to non-experts in interpreting official Party language, and that disappointment was expressed around the world and even within China. In response, the Party accelerated the release of its 60-point "Decision on Major Issues Concerning Comprehensively Deepening Reforms," a document that provided much more specificity to the reforms that are contemplated, and which were presumably approved by the Central Committee.

The economic growth of China has slowed down significantly, although it still impressively remains above 7 percent. While some of this slowdown may be transitory, due to a weak world economy, much of it is more durable, for at least four reasons. First, China's "demographic dividend" – a rise in the ratio of the working age population to total population – has ended, and will soon go into reverse as the number of retired people rises rapidly. Second, the migration from low-productivity farming into higher productivity mainly urban jobs has slowed, as the most mobile people have already moved and attachment to land-use rights inhibits others from moving. Third, rate of return on China's unusually high investments, especially those of state-owned enterprises (SOEs), has begun to decline significantly. Fourth, China has become the world's largest exporting country, and can no longer expect exports to grow at double-digit rates, as they did during the past thirty years.

The bottom line is that if China wants to continue to grow rapidly, it needs a new growth model, or at a minimum it needs to reverse significantly several of the factors leading to the decline. The decisions of the Third Plenum should be interpreted in light of this background.

On the demographic front, the authorities intend to relax the one child policy, to the effect that if one of two parents is a single child, the parents will be allowed to have two children rather than only one . This is a sensible change, but two questions can be raised: why was the rule not liberalized even more, given the rapid aging of society? and will relaxation of the rule have a quantitatively significant effect? The answer to the first probably lies in traditional Chinese caution, re-enforced by the presence of a large bureaucracy that attends to enforcement of the existing policy. The answer to the second is: probably not. Birth rates are well below population reproduction rates (2.1 children per woman of child-bearing age) in all other East Asian countries, from Japan to Singapore, even though none of them has a limit on number of children (and indeed Singapore is actively encouraging more children). And according to one report only eight percent of eligible parents in Shanghai took advantage of the 2008 change that allowed two children when both parents were single children. So very likely, except

perhaps in the aging country-side, most newly eligible parents will not elect to have a second child. But we will see.

The 60-point document has many provisions to improve conditions in agriculture, including allowing enterprise production, and for farmers, including allowing them to sell non-cultivated land and land-use contracts, and allowing them to move into towns and smaller cities with full rights of residents (but not into the larger cities, where social services are under strain).

The 60-point document also contains many provisions for raising the return to investment, partly by improving the efficiency of SOEs, partly by providing greater scope for growth of more profitable private enterprises by enlarging their allowable field of activity (e.g. into providing hospitals, military products and repair), partly by creating a more even competitive playing field with SOEs.

The key inputs to industry – energy, credit, etc. – are to be determined by market forces, thereby reducing the implicit subsidies many firms receive through existing price controls. SOEs are to be more greatly governed by profitability, with managers held correspondingly accountable. They are to be subject to more competition from non-public entities. In addition, SOEs are to pay 30 percent of their profits to the government by 2020 (revenues to be used to help finance an improved social safety net), up from less than 15 percent today. This is a curiously specific provision in a document largely drafted in general terms. Why not by 2015 instead of 2020? And why not 70 percent, or even 100 percent, instead of 30 percent? But, it will be argued, SOEs need to continue investing to respond to a growing economy. And so they must. But must they do it out of retained earnings, where managers do not need to meet a market test to justify their planned investments? A case can be made that established corporations should be required to distribute all of their earnings to shareholders, after building small reserves for unforeseen contingencies. For new investment they should have to compete with everyone else for bank credit or market credit. In China's case, requiring much higher distribution of profits by 2020 would help to build the currently weak corporate bond market, among other objectives. It should be noted that this recommendation applies to all countries (accomplished through much higher taxes on undistributed profits), not just to China, and that no other country has adopted it fully.

There are no provisions particularly regarding export promotion, but several of the proposed actions would indirectly raise the importance of export demand by raising the share of export value that is added within China, so that a given level of exports would contribute more to China's output.

The 60-point document provides a fine and impressive list of reforms. It remains to be seen whether the top leadership can translate these reforms into effective action at the local level.